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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Secretary Of The Navy

ORIGINAL

Navy's Progress In Implementing The Federal Managers' Financial Integrity Act

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GAO reviewed 23 federal agencies' continuing efforts to implement the Federal Managers' Financial Integrity Act of 1982. The act was intended to help reduce fraud, waste, and abuse in the federal government through annual agency assessments of internal controls and accounting systems and correction of systems' weaknesses.

This report focuses on the Navy's progress and efforts to correct identified weaknesses in its internal controls and accounting systems and efforts to improve its assessment program.

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SEPTEMBER 27, 1985

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

B-216946

The Honorable John F. Lehman
The Secretary of the Navy

Dear Mr. Secretary:

This report presents the results of our review of the Navy's efforts to implement and comply with the Federal Managers' Financial Integrity Act (FIA) of 1982 [31 U.S.C. 3512 (b) and (c)]. The act seeks to strengthen internal control and accounting systems in federal agencies to help detect and reduce fraud, waste, and abuse, and thereby improve government management. Our review was part of a governmentwide assessment of 23 agencies' continuing efforts to implement the FIA.

The Department of Defense's (DOD's) implementing instructions require each component to submit two annual reports to the Secretary of Defense. The instructions require one report to state whether systems of internal accounting and administrative controls, taken as a whole, fully comply with the act's requirements. The act requires that controls be established in accordance with standards prescribed by the Comptroller General and provide reasonable assurance that (1) obligations and costs comply with the law, (2) assets are safeguarded against waste, loss, unauthorized use, and misappropriation, and (3) revenues and expenditures are properly recorded and accounted for. Any material weaknesses, along with plans and schedules for their correction, must also be reported if controls do not fully comply with the act's requirements. The second report must state whether accounting systems conform to the principles, standards, and related requirements prescribed by the Comptroller General (hereinafter referred to as the Comptroller General's requirements).

The objectives of our review were to

--evaluate the Navy's progress in implementing its program for evaluating systems of internal control and accounting,

--determine whether actions taken as a result of the act are improving internal controls and accounting systems, and

--assess the adequacy of the basis for the Navy's determining that the requirements of the act have been met and that accounting systems do or do not conform with the Comptroller General's requirements.

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Appendix I contains detailed information on the objectives, scope, and methodology of this review. Appendix V is a glossary of the FIA terms used in our report.

In November 1984, your report to the Secretary of Defense stated that, taken as a whole, the Navy's evaluation of its internal controls provided reasonable assurance that the objectives of the act were being met. The report identified 38 material Navy-wide and organization-specific internal control weaknesses, along with actions taken and planned for correcting the weaknesses. You also stated that 5 of the Navy's 14 accounting systems substantially conformed with the Comptroller General's requirements, whereas 9 did not conform.

We found that the Navy made progress during the past year in developing and implementing its internal control evaluation program and in reviewing its accounting systems for conformance with the Comptroller General's requirements. The Navy increased its organizational and functional coverage; conducted more assessments of the risks of fraud, waste, and abuse; completed an inventory of its accounting systems; and evaluated two major accounting systems and two subsystems. Navy officials identified and corrected hundreds of weaknesses at the command and activity level. They stressed that increased consciousness of internal controls by the managers had been a major benefit of the program. Although progress was made in implementing the program, we believe the Navy's evaluation program did not evolve to a point that it provided an adequate basis to determine that Navy's systems of internal controls, taken as a whole, met the requirements of the act.

BETTER BASIS NEEDED TO DETERMINE IF NAVY INTERNAL CONTROLS AND ACCOUNTING SYSTEMS MEET THE ACT'S REQUIREMENTS

In deciding whether an agency has an adequate basis for determining that its systems of internal and administrative controls, taken as a whole, meet the requirements of the act, we believe the agency head must consider the (1) significance of the weaknesses disclosed, (2) status of corrective actions, (3) comprehensiveness and quality of the management control evaluation work performed, and (4) extent to which accounting systems conform to the Comptroller General's requirements.

Navy has significant internal control and accounting systems weaknesses

In your fiscal year 1984 evaluations of internal controls and accounting systems, the report identified material weaknesses for which corrective action has been taken or is planned. Specifically, the report identified 38 material internal control weaknesses of which 12 were Navy-wide, and the remainder

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pertained to a specific command or activity. In addition, you reported 71 specific accounting system deficiencies. Appendix II summarizes the internal control material weaknesses and appendix IV discusses the accounting deficiencies. The following are examples of these weaknesses reported and the potential significance or risk associated with them.

1984 Reported Material Weaknesses	Significance or Risk of the Problem
Navy-wide:	
Navy shipyards were not adequately timing material deliveries to meet overhaul production schedules and materials were not being ordered based on usage history.	Although specific dollar risks were not identified, Navy believes this weakness increased the potential for material losses; contributed to excess material inventories; and increased overhaul costs.
Navy could not determine if Federal Employee Compensation Act costs are reasonable and accurate.	These costs, which approximate $140 million per year, might involve erroneous or improper charges.
Twenty-eight Navy activities failed to bill or collect support service costs provided to credit unions.	As a result, Navy did not recover $308,000 in support service costs.
Navy word processing systems were being used for unofficial purposes.	Nearly 20 percent of word processing systems audited contained nongovernment material such as term papers, resumes, raffle tickets, and club agendum.
Navy purchased aviation and ship spare parts in some instances, at higher prices than might have been available from other sources or through other methods of procurement.	In addition to the financial losses attributable to this weakness, considerable adverse publicity has been given to DOD's multimillion dollar spare parts program.
Command-specific:	
A Navy hospital did not identify its facilities maintenance requirements and failed to control maintenance work or review monthly billings.	Navy could have been paying $239,000 to $448,000 each year, more than necessary for maintenance work.

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1984 Reported Material Weaknesses	Significance or Risk of the Problem
A Navy command needs to improve controls to adequately safeguard nonappropriated fund investment certificates held at a bank.	Nonappropriated fund investment certificates totaled over $108 million.
An inventory due-in/due-out file at one command contained entries for terminated procurements as well as duplicative entries.	About $13.2 million of materials were due-in for terminated procurements and about $507,000 due-in entries were duplicative. As a result, these invalid entries distorted stock availability data and overstated assets.
A Navy inventory control point did not maintain all planned program requirements covering replacements for parts taken from inactive aircraft.	About $4 million of funded program requirements were invalid and should have been cancelled.
A Naval shipyard did not have effective controls and accountability over tool inventories.	Auditors could not account for $4 million of the tool inventory valued at $16.2 million.

The Navy also reported the absence of automated data processing (ADP) contingency plans as a command-specific problem, although it may be Navy-wide. Such plans should provide among other things, procedures, backup files, and alternate sites for ADP systems to minimize service disruptions. It is important for the Navy to have approved, tested contingency plans because it is highly dependent on ADP support to achieve missions such as logistics support, weapons procurement, and aircraft and ship overhauls--and spends about $1.6 billion a year on ADP systems support. In a draft of this report sent to DOD for review and comment, we included a statement made to us by a senior Navy ADP official that the lack of formal ADP contingency plans is a serious Navy-wide problem. In commenting on the draft, DOD felt that the opinion of one management official was not sufficient to support that this is a Navy-wide problem. We agree. Although the scope of our work prohibits us from arriving at a firm conclusion on this matter, we found that five of the seven ADP facilities we visited did not have formal contingency plans as required by Navy regulations.

Navy has taken corrective actions

The Navy reported that it corrected or was in the process of correcting 27 material weaknesses reported in fiscal year

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1983. We reviewed five reported weaknesses and verified that corrective actions had been taken. The following are examples of the reported corrective actions:

--The Navy instituted improved management controls to correct significant weaknesses in material inventory practices at various Navy activities. The four Navy Audit Service reports on which this weakness was based identified potential cost savings of about $2 million.

--The Navy implemented a long-term Foreign Military Sales Improvement Program to better identify and bill foreign military customers to recover applicable costs under this multibillion dollar program. The Navy collected over $700,000 from a Foreign Military Sales customer who had not been properly charged for all costs and surcharges. The Navy continued to review controls and reported a $2 million underbilling as a 1984 material weakness.

--One Navy activity added personnel and improved procurement practices to help assure the most economical method for acquiring spare parts for training devices.

Although Navy managers generally took appropriate actions to correct identified internal control problems, they do not routinely test corrective actions to determine effectiveness. We believe that testing should be part of the corrective action process and that it should be completed before material weaknesses are removed from the Navy's tracking and follow-up systems.

Internal controls evaluation program not yet fully implemented

Using the Navy's first year efforts as a baseline against which to measure 1984's evaluation program, we believe the Navy achieved greater organizational coverage and its internal control evaluations were more effective. Most of the Navy's commands and activities participated in the FIA program. Further, the Navy subdivided its major functions into assessable units that were better tailored to their organizations. For example, a "supply" function could be subdivided into assessable units such as warehousing operations, receipts, and storage. This action, coupled with wider coverage, significantly increased the number of vulnerability assessments performed.

Despite this progress, we believe the Navy's FIA evaluation program needs to evolve further to provide an adequate basis for determining that its internal control systems, taken as a whole, meet the requirements of the act. We found that many of the activities visited had not established required tracking and follow-up systems to monitor and ensure that internal control

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deficiencies were promptly corrected. In addition, in order to ensure the comprehensive coverage of the Navy's FIA program, we believe ship and aircraft squadron managers should also perform internal control evaluations.

The Navy recognizes that several improvements are needed to achieve a quality program and is emphasizing consistent, good quality management control reviews, particularly documenting the control process and testing control techniques. The Navy is disseminating a self-instructional course on conducting internal control reviews which it believes, when combined with better direction and quality assurance techniques at the local level, will achieve the desired improvements. In addition, managers responsible for assessing ADP general and application controls are being made aware that (1) guidance is available to them and (2) compliance with the Office of Management and Budget (OMB) circular on ADP security does not alone meet the FIA requirements. Finally, a Navy official informed us that ship and aircraft squadron commanders will be required to evaluate internal controls starting in fiscal year 1986. Appendix III supplies specific information on these areas.

Most accounting systems do not conform with Comptroller General's requirements

The FIA requires agencies to report annually whether their accounting systems conform with the Comptroller General's requirements. According to the 1984 report to the Secretary of Defense, 5 of 14 accounting systems substantially met these requirements, while 9 did not.

However, the Navy did not adequately evaluate and test in operation any of the five systems it reported as being in conformance. Instead, the Navy relied on the results of a questionnaire--an approach we found inadequate. Accordingly, we do not believe that the Navy had an adequate basis for reporting that the five systems were in conformance with the Comptroller General's requirements.

A questionnaire technique can be helpful in measuring managers' perceptions and identifying certain potential accounting system deficiencies. However, we believe the questionnaire technique should be augmented by an evaluation of the system in operation, including testing, to determine how well the system actually works. Although agency personnel may be knowledgeable of how the system should work, in actual practice, systems may not operate as designed. Therefore, testing should be done on critical aspects of the system in operation.

Naval officials recognized the limited value of the questionnaires and planned to determine whether the questionnaire process should be continued, and if so, whether it should

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be modified. In any event, testing of the system in operation is essential to assessing conformance and should be part of whatever evaluation method is adopted.

The Navy did, however, take steps to improve its system evaluation process in 1984 by setting up a framework for determining whether its accounting systems meet the Comptroller General's requirements. For example, the Navy (1) developed and validated its inventory of accounting subsystems in operation and under design and (2) performed reviews of 2 of its 14 major accounting systems, 1 of 181 subsystems in operation, and 1 of 20 subsystems under design.

However, the Navy's efforts to bring its systems into conformance with the Comptroller General's requirements could be delayed for the following reasons:

--The Navy developed a draft master plan to monitor accounting system deficiencies and related corrective actions. However, since 1983, six of the planned corrective actions have slipped at least 1 year. We believe Navy decisionmakers would find this plan more helpful if it included and tracked interim and final milestone dates and estimated costs for all corrective actions. The Navy's FIA report to the Secretary of Defense should also include final milestone dates for all corrective actions.

--The Navy field and headquarters managers did not adequately coordinate internal control reviews with accounting systems evaluations. At the field level, these evaluations were performed independently; while at the headquarters level, the internal control weaknesses were generalized into such broad categories that relating those weaknesses to specific accounting subsystems was not possible.

--The Navy did not develop an adequate follow-up system to track and monitor accounting system deficiencies and related corrective actions. Such a system is essential to monitor and assure that actions developed to correct accounting system deficiencies are promptly completed.

Appendix IV contains details on our accounting systems findings.

CONCLUSIONS

Overall, the Navy made progress in developing and implementing its FIA program. It has achieved better organizational coverage and increased significantly the number of risk assessments against fraud, waste, and abuse. Because of the magnitude

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of the Navy's programs, activities, and functions, it can be expected that differing opinions would exist on the adequacy of the basis for determining the status of its internal controls; certainly this judgment is hard to make. Although the basic framework for an effective program has been established within the Navy, more must be done before it will provide an adequate basis for determining that Navy's internal controls, taken as a whole, comply with the requirements of the act.

The Navy has reported a number of significant material weaknesses and is taking actions to correct them. However, the Navy does not routinely test corrective actions to determine their effectiveness. We believe this is necessary before a material weakness is removed from the Navy's tracking and follow-up system. Additionally, Navy officials recognize that the program must emphasize better and more consistent quality internal control evaluations. Finally, to ensure basic accountability over its assets, the Navy's accounting systems must be brought more into line with the Comptroller General's requirements.

The Navy has also made progress in evaluating its accounting systems. However, we believe the Navy does not have an adequate basis to report that five of its accounting systems substantially conform with the Comptroller General's requirements. This is because Navy has not adequately evaluated and tested any of its five accounting systems in operation.

RECOMMENDATIONS

We recommend that the Secretary of the Navy's future annual statements on systems of internal accounting and administrative controls not report that the systems, taken as a whole, provide reasonable assurance that the requirements of the act have been met until such time as the revised evaluation program provides an adequate basis to make such a determination.

We also recommend that accounting systems not be reported in conformance with the Comptroller General's requirements until they have been adequately evaluated and tested in operation. We recommend further that the Navy should

--fully coordinate all work performed under provisions of the FIA, at both the field and headquarters levels, to better identify accounting internal control weaknesses and needed corrections to specific accounting systems and

--implement an effective tracking and follow-up system to monitor planned accounting systems corrective actions on an ongoing basis.

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AGENCY COMMENTS AND OUR ANALYSIS

DOD's official comments on our draft report are contained in appendix VI. DOD generally agreed with the facts in our report and stated that the Navy has taken or initiated actions to address evaluation program problems we identified which could strengthen the overall Navy program. For example, in April 1985, the Navy provided managers with DOD ADP internal control guidelines and it currently plans to establish and maintain tracking and follow-up systems and to ensure that actions to correct deficiencies are tested for effectiveness. In addition, the Navy is drafting program guidance that will ensure that ship and aircraft squadron commanders are complying with the act. DOD disagreed with a statement in our draft report, attributed to a senior Navy ADP official, that the lack of ADP contingency plans is a Navy-wide problem. Our report has been revised to reflect DOD's comment. See page 4.

DOD agreed with two of our recommendations and stated that the Navy intends to fully coordinate work to better identify and correct accounting internal control weaknesses, and to implement an effective tracking and follow-up system to monitor planned accounting systems corrective actions. As discussed more fully below, DOD did not agree with our conclusion and related recommendation concerning the adequacy of the Navy's basis for determining that its internal control systems, taken as a whole, meet the requirements of the act. Furthermore, DOD only partially concurred with our recommendation that accounting systems not be reported in conformance with the Comptroller General's requirements until they have been adequately evaluated and tested in operation.

Disagreement on the basis for determining that requirements of the act had been met

In disagreeing with our conclusion and recommendation on the adequacy of the Navy's basis for determining that its internal control systems, taken as a whole, meet the requirements of the act, DOD noted that our criterion for determining compliance with the act was incomplete because we failed to consider the "total management process" used by the Navy to support its reasonable assurance statement. This management process includes audit, inspection, internal review, and investigative activities, and any other information bearing on the subject of internal controls.

We agree that alternative sources of information on the effectiveness of controls are important. DOD's FIA evaluation program regulations require that managers consider data from all sources (particularly from the audit community) when determining

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vulnerabilities, and as alternatives to conducting detailed internal control reviews. In this respect, DOD regulations are in accordance with FIA guidelines that were established jointly by OMB and by us in 1982. However, although audits and inspections may have detected particular instances of fraud, waste, and abuse, they rarely have the scope necessary to allow managers to determine the status of controls within entire functions or their organizations as a whole.

In order for Navy's systems, taken as a whole, to provide the reasonable assurance required by the act, we believe Navy must have a comprehensive evaluation program. Navy must essentially do two things to meet the requirements of the act. First, it must ensure that internal control systems meet the Comptroller General's standards, which require that various control techniques within programs, functions and activities be designed to cost-effectively achieve all important control objectives, and that these systems provide the means for preventing fraud, waste, and abuse. Second, it must verify that key controls are being systemically implemented and are operating as intended. If not, corrective actions should be taken and then tested to determine whether weaknesses have been corrected.

As noted in our report, we found that the Navy's internal control program had not matured enough to determine that control systems, taken as a whole, meet the requirements of the act. Specifically, we found that the Navy needs to better document and test control techniques, ensure comprehensive FIA coverage by including ship and aircraft squadrons, and test corrective actions to determine their effectiveness. The Navy acknowledges it needs to improve its internal control evaluation program and as previously discussed, has taken action to address the problems noted in our report.

Our report also noted that the Navy's 1984 FIA report identified numerous internal control problems and accounting systems deficiencies that needed to be corrected. The Navy also reported that 9 of its 14 accounting systems were not in conformance with the Comptroller General's requirements. We believe that the significance of the control problems, and the extent to which accounting systems conform, are additional, important indicators of the overall status of controls.

Our report recognizes that because of the magnitude of the Navy's programs, activities, and functions, differing opinions can exist on the adequacy of the basis for determining the overall status of internal controls. Certainly such a judgment is difficult to make. However, considering the sum of all the information available to us, we continue to believe that the Navy did not yet have an adequate basis to determine that its

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systems, taken as a whole, meet the requirements of the act. As discussed previously, our report points out that the Navy has taken a number of actions to improve its internal control program. If implemented properly, we believe these actions could significantly enhance the Navy's future basis for determining the overall status of its internal controls and whether or not the requirements of the act have been met.

Disagreement on determining accounting systems conformance

Although DOD believes that the Navy had a sufficient basis for reporting that five accounting systems conformed, it agrees that evaluations and testings of accounting systems in operation need to be performed where appropriate in the future. We disagree with DOD's view that the Navy had a sufficient basis for determining the conformance status of its systems. The major effort used by the Navy to determine conformance status was a questionnaire, which the Navy came to recognize was of limited value and which we concluded was inadequate.

DOD points out that the Navy has embarked on a comprehensive consolidated systems evaluation and user/manager review process in accounting systems evaluations for fiscal year 1985 and the future. This approach is part of the integrated program the Navy has developed for its financial management evaluation and control process. Although, as pointed out on pages 26 and 27, we believe the Navy has improved its evaluation process, the Navy did not test any of the five systems it reported in conformance in 1984.

DOD officials advised that the Navy intends to comply with new DOD guidance which will establish objectives, criteria, and testing and documentation requirements for accounting systems evaluations. Further, DOD advised that future reports on accounting systems must indicate that conformance is based on transaction testing. We believe that if this guidance is implemented properly, the Navy will satisfy the intent of our recommendation.

. . . . .

As you know, 31 U.S.C. §720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

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We are sending copies of this report to the Chairmen of the above Committees and to the Chairmen of the House and Senate Committees on Armed Services, and the Budget. We are also sending copies to the Director, Office of Management and Budget, and the Secretary of Defense.

We appreciate the courtesy and cooperation extended to us during our review.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Director

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ABBREVIATIONS

ADP	Automated Data Processing
DOD	Department of Defense
FIA	Federal Managers' Financial Integrity Act
GAO	General Accounting Office
OMB	Office of Management and Budget

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OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to

--determine whether actions taken under the act have improved internal controls and accounting systems,

--evaluate Navy's progress in implementing its program for evaluating systems of internal control and accounting, and

--assess the adequacy of the basis for the Navy's reporting that the objectives of the act had been met and that accounting systems do or do not conform with the Comptroller General's requirements.

The majority of our work was done at the Office of the Assistant Secretary of the Navy for Financial Management, which is responsible for coordinating the internal control evaluation program. Our work was performed during the period July 1984 through March 1985. We visited the following Navy organizations located in Washington, D.C:

--Office of the Chief of Naval Operations,
--U.S. Marine Corps Headquarters,
--Office of the Comptroller of the Navy,
--Office of Naval Research,
--Military Sealift Command,
--Material Command,
--Supply Systems Command,
--Facilities Engineering Command,
--Sea Systems Command,
--Military Personnel Command, and
--Data Automation Command.

In addition, we performed work at the following major Navy commands and activities throughout the United States:

--Commander in Chief, Atlantic Fleet: Naval Air Forces and Surface Forces, Norfolk; Oceana Air Station; and Little Creek Amphibious Base.

--Commander in Chief, Pacific Fleet: Barbers Point Air Station; Pearl Harbor Naval Station; Lualualei Naval Magazine; Miramar Air Station; and San Diego Naval Station.

--Marine Corps: Barstow Logistics Base; Kansas City Finance Center, and Camp Pendleton, Oceanside,
--Navy Finance Center, Cleveland,

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--San Diego Supply Center,
--Norfolk Supply Center, and
--Pearl Harbor Shipyard.

At these organizations, we reviewed internal control program policies and procedures and other key documents such as vulnerability assessments, internal control reviews, and internal control status reports. We interviewed officials and other key personnel responsible for implementing the program and/or performing vulnerability assessments and management control reviews. We also reviewed five of Navy's fiscal year 1983 material weaknesses to determine the status of its corrective actions. In addition, we evaluated the assessment of and reporting on whether Navy's accounting systems were in conformance with the Comptroller General's requirements.

Because of the integration of ADP in Navy's programs and functions (e.g., financial, supply, and procurement), we examined the consideration given to ADP during the internal control evaluation process. We also reviewed ADP operations at the following organizations:

--Regional Data Automation Centers in Washington, D.C., Norfolk, and San Diego;
--Navy Data Automation Facility, Pearl Harbor;
--Marine Corps Central Design and Program Activity, Quantico; and
--Automated Data Systems Activity, Indian Head.

We limited our review to the Navy's FIA implementation and reporting process. We did not attempt to independently determine the status of the Navy's internal controls or the adequacy of the corrective actions taken to improve Navy's reported weaknesses.

Our review was performed in accordance with generally accepted government auditing standards.

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INTERNAL ACCOUNTING AND ADMINISTRATIVE CONTROL WEAKNESSES REPORTED TO THE SECRETARY OF DEFENSE IN THE NAVY'S 1984 FIA STATEMENT

The Secretary of the Navy's 1984 FIA report identified 12 Navy-wide and 26 organization-specific material weaknesses. The report listed the actions taken and the plans to correct the weaknesses. The following is a synopsis from the Secretary of the Navy's assurance letter, describing the 1984 reported departmentwide and organization-specific material weaknesses.

NAVY-WIDE MATERIAL WEAKNESSES

A. Program/Function: Supply

1. Inappropriate delivery and ordering schedules for ship overhaul materials. These deficiencies affect shipyards' financial solvency by hampering cost recoupment, increasing potential for material loss, contributing to excess material inventories, and increasing overhead costs.

2. Weaknesses in procedures for accounting and disposing of excess materials were identified.

3. Aviation and ship spare parts were occasionally purchased at considerably higher prices primarily due to noncompetitive procurement when alternative sources were available.

4. Procedures for recording issues of flight gear are inconsistent, contradictory, and discretionary.

B. Program/Function: Security

5. Several Navy and Marine Corps establishments have inadequate controlled access to bases and buildings, inadequate security training and security forces, inadequate visitor procedures, and excessive security requirements for small organizations.

C. Program/Function: Financial

6. There was inadequate assurance that only eligible members received career sea pay and that they were paid at the correct rate. Also, ship-based members who were not performing sea duty received career sea pay which they were not entitled to receive.

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7. Delayed reporting and/or lack of consideration of used leave balances resulted in substantial leave overpayment made to separated members.

D. Program/Function: Audit

8. The Internal Review Program has not been fully implemented due to lack of resources and training, and problems in position classification.

E. Program/Function: Personnel

9. Navy cannot validate the Federal Employee Compensation Act costs which are approximately $140 million per year. No controls exist to ensure that Department of Labor charges are reasonable and accurate.

F. Program/Function: Medical

10. Medical treatment facilities were inconsistently classifying emergency rooms. Care was provided by medical personnel inexperienced in emergency care. Inadequate staffing also resulted in numerous malpractice suits against the Navy.

G. Program/Function: Administrative Support

11. Data used to record real property leases and licenses to credit unions was inaccurate. Also, 28 Navy and Marine Corps activities with tenant credit unions failed to bill or collect about $308,000 in support services.

12. Out of 99 word processing systems audited, 20 percent contained nongovernment material due to weak internal controls and failure to enforce standards.

ORGANIZATION-SPECIFIC MATERIAL WEAKNESSES

A. Program/Function: ADP

1. Naval Electronic Systems Command's ADP security control techniques are documented, but do not contain formal implementing directives and procedures. Internal auditing is lacking and user guides are nonexistent or outdated for systems and remote work stations.

2. One of Navy Comptroller's activities had inadequate contingency plans and procedures for protecting

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systems specifications documents, thus making it susceptible to loss from fire, destructive weather, or other disaster.

B. Program/Function: Education and Training

3. The Chief of Naval Education and Training cannot effectively meet operational training responsibilities because the Trident Submarine training simulators are not being changed in tandem with actual operating fleet equipment.

C. Program/Function: Facilities and Base Maintenance

4. A hospital within Naval Medical Command may have overpaid between $239,000 and $448,000 annually for maintenance work because it failed to adequately identify its facilities maintenance requirements, control the maintenance work, and review the monthly billings.

D. Program/Function: Financial

5. The Naval Military Personnel Command failed to have adequate separation of duties, responsibilities, and procedures to safeguard $108 million of nonappropriated fund investment certificates and interest checks.

6. One activity within the Chief of Naval Operations discovered that its accounting system computer programs were malfunctioning, thus resulting in distorted, inaccurate, and untimely automated reports.

7. Funds from medical research projects within Naval Medical Command occasionally went to project managers rather than to a finance officer.

8. A local national payroll computer program within Commander in Chief, U.S. Naval Forces, Europe, contained inadequate edit procedures. Input data for civilian personnel payrolls were sent without transmittal documents required for feedback.

9. A Naval Regional Contracting Center within Naval Supply Systems Command incurred liabilities without properly obligating funds when indefinite delivery/indefinite quantity contracts were executed.

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E. Program/Function: Maintenance, Repair, and Overhaul

10. Naval Air Systems Command revealed numerous deficiencies at aircraft maintenance facilities, such as (1) inadequacies in the budgeting system, (2) inadequate administrative control and maintenance procedures for materials handling equipment, (3) untimely supply support for bit piece items, and (4) work expenditures exceeding the standards for performing the work.

F. Program/Function: Medical

11. Medical equipment within Naval Medical Command was not receiving required preventive maintenance, thus creating a life threatening situation if equipment should fail.

G. Program/Function: Military Assistance

12. The Naval Material Command identified that one foreign government was not properly charged for approximately $2 million in costs because the Case Administrating Office did not receive all charges related to two weapon systems and a sonar.

H. Program/Function: Morale, Welfare, and Recreation

13. Several field activities within Naval Facilities Engineering Command identified major deficiencies in complying with established policy and procedures. These deficiencies involved lack of basic controls in handling cash, managing inventories, and accounting for property.

14. Audit reports and subordinate activities within Commander in Chief, U.S. Atlantic Fleet, reported numerous deficiencies in Ship Store operations. These deficiencies included (1) the quality of personnel assigned within the Ships Serviceman rating and (2) deficient training and compliance with Ship Store inventory, cash handling, and systematic check and balance procedures.

15. An audit of morale, welfare, and recreation at one field activity within U.S. Atlantic Fleet identified weak internal and cash controls, inadequate trained personnel, and poor documentation. The organizational structure was not properly aligned. Also, retail accountabilities and required inventories were not conducted.

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16. Naval Supply Systems Command reported deficiencies at a consolidated officer's mess, including inadequate controls over mess sales, buying and receiving merchandise, consumable inventories, and the pay system.

I. Program/Function: Procurement

17. A Naval Ordinance Station within Naval Sea Systems Command split procurement actions of about $548,000 so that the $25,000 purchase order limitation was not exceeded, thus circumventing purchase and approval authority limitations.

18. A Supervisor of Shipbuilding Conversion and Repair continually negotiated price proposals with a contractor whose estimating system was inadequate and incapable of producing valid support for cost proposals.

19. A Pacific Fleet activity did not conduct full technical research or supply sufficient technical data for nonstandard requirements in order to cross identify with standard stock. Other field activities have procured unauthorized material, and last minute planning resulted in abuse of priorities.

J. Program/Function: Property Management

20. A shipyard within Naval Sea Systems Command did not have effective controls and accountability over $16.2 million in toolroom or toolcrib inventory, nor could auditors account for 25 percent of tool assets.

K. Program/Function: Supply

21. An inventory control point within Naval Supply Systems Command did not maintain or adequately document all planned program requirements, thus the Navy requisitioned about $4 million in aircraft parts that should have been cancelled.

22. A Naval Supply Systems Command inventory control point audit identified over $13.2 million of material due-in from procurements that had been terminated and $507,000 in duplicated due-in procurements. These invalid procurements adversely impact on supply management decisions by distorting stock availability data and overstating assets.

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23. Audits at various field stations within the Naval Security Group Command identified a lack of controls to provide adequate accountability of stocked parts.

24. Servmarts and General Services Administration Self-Service Stores in Naval Air Systems Command did not have proper control over purchases. Deficiencies included (1) unnecessary stockpiling, (2) lack of security and supervisory review, and (3) procedures that allowed items to be added to the purchase document after authorized signatures.

L. Program/Function: Transportation

25. Reviews conducted within the Commander in Chief, U.S. Naval Forces, Europe, identified that controls were weak over fuel, gas coupons, toll tickets, spare parts, and supplies.

26. Three Public Works Centers within Naval Facilities Engineering Command reported serious fuel control deficiencies.

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THE NAVY CAN STRENGTHEN ITS PROGRAM TO EVALUATE INTERNAL CONTROLS

The Navy has demonstrated progress in its continuing effort to comply with the FIA. Increased organizational coverage and more meaningful internal control evaluations were the more commendable improvements. However, our review identified some improvements that are needed to strengthen the program. We suggest the Navy concentrate its efforts on requiring ship and aircraft squadron commanders to conduct internal control evaluations and developing more tracking and follow-up systems, including testing the effectiveness of corrective actions and improving ADP quidance.

Last year, we discussed in our report[1] how critical it was that the Navy follow through on its plans to establish internal control evaluation procedures, and the Navy has taken action toward this end. Within the last 2 years, the Navy established and clarified a number of written procedures to guide the commands and activities in implementing a satisfactory internal control program. However, the next step in establishing a quality program is to place greater emphasis and attention on ensuring compliance with these procedures.

DEPLOYABLE FORCES MAY NOT BE CONDUCTING INTERNAL CONTROL EVALUATIONS

Despite the Navy's increased organizational coverage in 1984, ships and aircraft squadron managers may not be conducting internal control evaluations. In December 1983, the Chief of Naval Operations exempted these forces from internal control reporting requirements, while not exempting them from full FIA compliance. As a result, confusion existed within the Navy as to whether these ships and squadrons were evaluating internal controls as envisioned under the act.[2] However, we were informed that the Chief of Naval Operations will rescind the 1983 waiver, and ships and aircraft squadrons will be required to conduct internal control evaluations beginning in fiscal year 1986.

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[1]Department of the Navy's First-Year Implementation of the Federal Managers' Financial Integrity Act (GAO/NSIAD-84-94, May 1, 1984).

[2]DOD implementing instructions require a comprehensive evaluation of internal controls by managers within all major organizational and functional subdivisions to ensure that the objectives of the act are met.

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ADP COVERAGE IMPROVED
BUT BETTER GUIDANCE NEEDED

Last year, in implementing FIA, the Navy's coverage of ADP was inadequate to meet requirements of the act. Of the major commands required to evaluate internal controls in fiscal year 1983, only 12 assessed ADP. Also, all of the assessments were performed at the command level and the results may not have reflected a realistic status of ADP internal controls at the activity level.

In 1984, the Navy increased coverage to include the activity level, such as data processing facilities and the functional users of data processing systems. We found that ADP general and application controls were usually assessed if they were a part of the activities' mission.

Although the Navy made improvements in assessing ADP during fiscal year 1984, two problems remain. First, managers responsible for assessing ADP general and application controls are generally not aware of the DOD and Auditor General's guidance available to them. As a result, some ADP controls were not adequately considered. Second, managers mistakenly believe that the FIA requirements are being met by complying with the OMB Circular A-71--the Circular on ADP security.

We believe the Navy instruction on FIA (SECNAV 5200.3) should reference the DOD ADP internal control guideline issued in November 1984, and the Navy Auditor General's audit program. The DOD ADP guidelines provide a good discussion on managers' responsibilities for ADP internal controls and on control objectives and techniques. The DOD guidelines fully address both FIA and OMB circular requirements. We also believe the Navy Auditor General's audit program provides a useful checklist for reviewing ADP systems internal controls.

We believe that the Navy FIA instructions should state that FIA requirements cannot be met by only complying with OMB Circular A-71. This circular only partially covers ADP general controls and does not address any ADP application controls. If ADP managers continue under the assumption that compliance with OMB Circular A-71 satisfies the FIA requirements, a portion of ADP general controls and all of ADP application controls will not be fully assessed.

MORE TRACKING AND
FOLLOW-UP SYSTEMS NEEDED

Progress in implementing tracking and follow-up systems varied among Navy activities. For example, only two of the eight major commands we visited have not implemented a formal

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APPENDIX III

tracking and follow-up system. However, 12 of the 15 field activities had no systems in place as of December 1984, although several activities were considering implementing them soon. Such systems are essential to monitor and assure that actions developed to correct internal control deficiencies are completed. Therefore, the Navy could progress significantly in its future FIA effort by implementing the required tracking and follow-up systems throughout the Navy.

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THE NAVY CAN STRENGTHEN ITS ACCOUNTING SYSTEMS AND IMPROVE ITS SYSTEM EVALUATIONS

The Navy recognizes that there are major deficiencies in its accounting systems and that substantial work is needed before its systems fully conform with the Comptroller General's requirements. To correct these known system deficiencies, the Navy continued working on a number of long and short term efforts. Further, during 1984 the Navy began evaluating its accounting systems to identify additional system deficiencies and needed corrective actions. As major deficiencies are corrected and major systems are adequately evaluated the Navy will have a better basis for determining whether accounting systems conform with the Comptroller General's requirements.

In its 1984 FIA report, the Navy identified major accounting system deficiencies and reported that 9 of its 14 accounting systems did not conform with the Comptroller General's requirements. We do not believe, however, that the Navy had an adequate basis to report that 5 of 14 accounting systems substantially conformed with the Comptroller General's requirements because the Navy did not sufficiently review and test these 5 systems in operation.

STATUS OF ACCOUNTING SYSTEMS PROBLEMS AND CORRECTIVE ACTIONS

The Navy reported major problems

In the 1984 FIA report, the Navy summarized its accounting system problems into 10 major categories, such as information not meeting user needs and inaccurate and untimely accounting data. Within these 10 major categories, the Navy reported 71 specific system deficiencies, including 39 of the 40 deficiencies that were contained in its 1983 FIA report. Some deficiencies reported in 1984 are discussed below.

--The Department of the Navy's accounting system, which provides summary level accounting for both the Navy and Marine Corps and accounts for about $136 billion, does not have all accounts under complete general ledger control. A complete general ledger is necessary because it provides control over the integrity of data in the system and the reliability of financial reports.

--The Navy military pay accounting system, which processes about 1 million active, retired, and reserve military pay records, does not produce accurate, consistent, and timely information. The Navy reported that as a result,

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incorrect amounts were sent to the Internal Revenue Service on federal income tax withholding, incorrect amounts were paid to active military personnel, and duplicate payments were made to retirees or annuitants.

--The Navy civilian pay accounting system, which processes about 300,000 civilian pay records, operates on outdated computer hardware and software. The Navy reported that as a result, the system is both costly to operate and maintain and is difficult to modify.

--The Marine Corps' general accounting system, which accounts for about $8.2 billion, does not satisfy management information needs. For example, the system does not fully provide for the general ledger control of assets held in inventories or management information on inventory usage. This information is needed for effective management control over the maintenance, use, and disposition of these assets.

The Navy's planned corrective actions

The Navy recognizes major deficiencies in its accounting systems and has continued working on long and short term efforts to correct them. In 1984, the Navy developed a draft strategic financial management master plan which contains long and short term actions to correct system deficiencies. We endorse the use of such a plan. However, since six planned actions have already slipped since 1983, we believe that both the master plan and the FIA report can be made more useful to Navy decisionmakers in monitoring these efforts if these documents also included milestone dates and estimated costs for implementing corrective actions.

The Navy's efforts to correct most of the deficiencies will not be completed until the late 1980s, although the Navy made progress during 1984 in improving some of its accounting systems by implementing interim corrective actions. For example, the Navy fully implemented the Pay Enhancement Program at U.S. shore activities and continued to implement the Uniform Micro Computer Disbursing System aboard ships and at overseas activities. Both of these systems represent interim measures to reduce the time required to transmit pay data to the Navy Regional Finance Center which operates the Navy military pay system.

Although the Navy improved some of its accounting systems through these interim measures, most corrective actions involve longer term efforts. Currently, the Navy has 20 accounting systems under design and 38 major system enhancement efforts underway. Some of these projects include

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--implementing one standard system by 1986 to replace 20 Navy civilian pay systems and

--developing and implementing a standardized accounting, budgeting, and reporting system in the Marine Corps by 1989.

It is important that the Navy effectively manage these long term projects so that they are implemented on schedule and correct system deficiencies. Some projects, however, have already slipped. For example, 20 of the 58 planned corrective actions had implementation dates and 6 of those actions have already slipped about 1 year. Further, the Navy must evaluate these new or redesigned systems to ensure that they conform with the Comptroller General's requirements.

FIA annual reports and master plans could become useful management tools to track actual progress and problems. However, the use of these two documents would be improved if additional information were shown in them. For example, the 1984 FIA report did not always include scheduled implementation dates for planned corrective actions. Further, the 1984 draft master plan did not always include interim milestone dates or estimated project costs. We believe that inclusion of this information would allow Navy decisionmakers to more effectively monitor accounting systems improvements.

PROGRESS AND PROBLEMS IN EVALUATING ACCOUNTING SYSTEMS

Since last year, the Navy has improved its system evaluation process and established an effective framework for determining whether its accounting systems conform with the Comptroller General's requirements. For example, the Navy (1) developed and validated its inventory of accounting subsystems in operation and under design, (2) conducted reviews of 2 of its 14 major accounting systems, using a high level management approach, and (3) developed procedures and conducted two comprehensive reviews of its subsystems. Although progress was made during 1984, the Navy did not (1) adequately evaluate and test its accounting systems, (2) adequately coordinate work done under sections 2 and 4 of FIA, and (3) develop an adequate follow-up system to track system deficiencies and related corrective actions.

Progress made in evaluating accounting systems

The Navy did a good job in developing a comprehensive inventory of its accounting system, which includes 14 major

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accounting systems and 181 accounting subsystems. The development of an effective inventory will enable the Navy to schedule all significant systems for evaluations. During 1984, the Navy performed two reviews of its 14 major accounting systems and two reviews of its accounting subsystems.

The Navy effectively completed high-level management reviews of the general accounting system and the military pay accounting system. This innovative evaluation approach involved senior managers spending several months reviewing the functional processes of the two systems and the flow of information from the systems to users. They also met with system managers and users to obtain their views on the system. These reviews identified major system deficiencies and necessary corrective actions. For example, the general accounting system review identified 14 major problems and 24 specific actions needed to correct deficiencies.

Similarly, we found the Navy's comprehensive system review approach effective. In 1984, the Navy developed procedures for conducting reviews of its accounting subsystems, both those in operation and those under design. Using these procedures, the Navy effectively evaluated two accounting subsystems. For example, the Research and Development Management Information System evaluation identified 9 major deficiencies, including 208 potential internal control weaknesses, and recommended 13 actions which need to be completed before this system becomes operational. In its comments to our draft report (see p. 39), DOD describes the Navy's evaluation process in more detail.

The Navy did not adequately evaluate and test accounting systems

Although the Navy made progress in evaluating its accounting systems in 1984, it has not yet adequately evaluated (which includes testing in operation) its accounting systems, including the five systems reported as being in substantial conformance with Comptroller General's requirements. The primary method used to evaluate the accounting systems was the use of a questionnaire, which did not include testing of the system. We believe that the Navy must test its systems to properly determine conformance.

The Navy used a questionnaire to evaluate 27 of the 181 subsystems in operation. The questionnaire did not effectively identify system deficiencies because (1) the Navy's decision to use the questionnaire late in the year resulted in limited time to complete the document, (2) our prior reports and Naval Audit Service reports, identifying past deficiencies, were not considered in completing the questionnaire, (3) sections of the questionnaire responses were not completed, and (4) documentation to support questionnaire responses was not prepared. Further, the

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systems were not tested in operation, little evaluation of system interfaces was done, and no substantial input was given either by system users or ADP staff. In general, the reviews conducted, based on the questionnaires, were limited to an evaluation of system's manuals rather than an evaluation of the systems in operation.

A questionnaire technique can be helpful in measuring managers' perceptions and identifying certain potential accounting system deficiencies. However, to determine whether a financial system conforms to principles, standards, and related requirements prescribed by the Comptroller General, it is necessary to review and test the system in operation. Although agency personnel may have extensive system knowledge, systems may operate differently than they believed. Therefore, testing should be done on critical aspects of the system, and may include interviewing persons who operate the system; observing control procedures; examining system documentation; applying procedures on live transactions and comparing results; directing tests of computer-based systems by use of simulated transactions; and reviewing error reports and evaluating error follow-up procedures.

Tests should be designed to disclose whether valid transactions are processed properly, and whether the system rejects invalid transactions. The tests should cover the entire transaction, from initial authorization through processing, posting to the accounts, and reporting. Accordingly, manual as well as automated operations should be included. In developing test plans, consideration should be given to the results of any prior system testing. This testing criteria has been adopted by OMB and included in appendix H of its publication, Guidelines for Evaluating Financial Management/Accounting Systems (May 20, 1985). In determining the tests that would be appropriate for any system, it is important to keep in mind that in most cases, more than one of the above techniques are needed to test all key aspects of an accounting system.

For the five systems reported as being in substantial conformance, the Navy did not perform (1) high level management reviews, (2) comprehensive reviews of related subsystems, or (3) tests of those systems in operation. In 1984, the Navy completed questionnaires on some of the accounting subsystems. However, as discussed previously, the questionnaires did not provide an adequate basis for evaluating the subsystems. As we mentioned in last year's report, we believe it will be necessary for the Navy to evaluate its systems in operation, including testing, prior to reporting to their conformance.

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The Navy did not adequately coordinate internal control reviews with accounting systems evaluations

The Navy's field and headquarters managers did not adequately coordinate management control and accounting systems' evaluations. At the field level, these evaluations were usually considered separate, stand-alone efforts. At the headquarters level, coordination could not be done because the accounting internal control weaknesses were summarized into such broad categories, relating those weaknesses to specific accounting subsystems was not possible. As a result, internal accounting control weaknesses identified during management control review efforts were not tied back to specific accounting subsystems. Examples of internal control weaknesses that also impact on the accounting systems follow:

--Deficiencies in the administration and control over travel advances result in inaccurate recordings of obligations in the accounting system.

--Orders for about $13.2 million of materials still being shown as open had actually been terminated during the prior 9 months. This resulted in an overstatement of assets in reports produced by the accounting system.

We believe the Navy should improve the coordination between its reviews of management controls and accounting systems, and relate reported accounting internal control weaknesses to specific accounting subsystems. This coordination will provide the Navy with more information on the status of the accounting systems and can help eliminate duplication of work done to meet the requirements of the act.

The Navy has not established an adequate system to track accounting system deficiencies

The Navy needs to improve its follow-up system to better track accounting system deficiencies and related corrective actions. The current manual follow-up system contains information only on corrective actions to be taken and planned implementation dates. A more comprehensive tracking and follow-up system will become essential as the number of identified deficiencies increases and more indepth data are accumulated.

Navy officials recognize the need for a better follow-up system and plan to implement an automated system in 1985, with most of the pertinent data coming from the Navy's master plan. We believe that if the Navy updates the master plan on an ongoing basis and includes all elements necessary to monitor its deficiencies and corrective actions, the master plan could be used as an effective tracking and follow-up system.

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Whatever follow-up system is used by the Navy to track deficiencies and related corrective actions, we suggest that at a minimum, it include: (1) all known system deficiencies, (2) planned corrective actions, (3) the office responsible for the corrective actions, (4) interim and final milestone dates for the corrective actions, (5) slippages of scheduled corrective action work, and (6) information on whether actions taken actually corrected the deficiency.

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GLOSSARY

We developed the following definitions that apply to our review of the implementation of the Federal Managers' Financial Integrity Act.

Accounting System

The total structure of the methods and procedures used to record, classify, and report information on the financial position and operations of a government unit or any of its funds, balanced account groups, and organizational components. An accounting system should assist in the financial management functions of budget formulation and execution, proprietary accounting, and financial reporting.

ADP Application Controls

Controls that are unique to each software application system. Application controls are intended to ensure the quality of data origination, input, processing, and output.

ADP General Controls

Controls that apply to the overall management of the ADP function in an agency. General ADP controls have a direct effect on the quality of service rendered to ADP users and cover the processing of all ADP application systems. These controls affect most ADP hardware and application software systems, and include:

--organizational controls for the ADP unit;
--system design, development, and modification controls;
--data center management controls;
--data center security controls;
--system software controls; and
--hardware controls.

These controls should be evaluated by ADP managers as part of an analysis of the general control environment.

Comptroller General's Requirements

Our Policy and Procedures Manual for Guidance of Federal Agencies contains the principles, standards, and related requirements to be observed by federal agencies. Specifically, title 2 prescribes the overall accounting principles and standards, while titles 4, 5, 6, and 7 specify requirements governing claims; transportation; pay, leave and allowance; and fiscal procedures, respectively.

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Also, agency accounting systems must include internal controls that comply with the Comptroller General's internal control standards and related requirements such as Treasury Fiscal Requirements Manual and OMB circulars.

Documentation

That information which would allow an independent reviewer to understand the rationale for conclusions the reviewer reached regarding an agency's internal controls, as well as the methods used, and personnel involved. This information should be current and be available for review. "Documentation" of internal controls is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

Internal Controls

The plan of organization and all coordinate methods and measures adopted by an agency to provide reasonable assurance that the three objectives of the Federal Managers' Financial Integrity Act of 1982 are achieved. Internal controls should be established in accordance with the Comptroller General's Internal Control Standards. Typically, an internal control represents the combination of a control objective, along with a control technique (or set of techniques) that is being relied on to achieve that control objective.

Internal Control Review

A detailed examination of a system of internal control to determine whether adequate control measures exist and are implemented to prevent or detect the occurrence of potential risks in a cost-effective manner. OMB guidelines recommend six steps for an internal control review: (1) identification of the event cycle, (2) analysis of the general control environment, (3) documentation of the event cycle, (4) evaluation of internal controls within the cycle, (5) testing of the internal controls, and (6) reporting the results. Internal control reviews should normally be conducted for those areas rated as highly vulnerable in the vulnerability assessment process, where corrective action is not readily apparent. An agency should allocate resources for these detailed reviews of internal control based on vulnerability. Those most vulnerable should be reviewed first.

Internal Control Standards

The Federal Managers' Financial Integrity Act of 1982 requires each executive agency to establish internal accounting and administrative controls in accordance with,

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among other things, standards issued by the Comptroller General. In 1983, the Comptroller General issued a set of 12 Standards for Internal Controls in the Federal Government. The standards include five general control standards, six specific standards, and an audit resolution standard. The five general standards are: (1) reasonable assurance, (2) supportive attitude, (3) competent personnel, (4) control objectives, and (5) control techniques. The six specific standards are: (1) documentation, (2) recording of transactions and events, (3) execution of transactions and events, (4) separation of duties, (5) supervision, and (6) access to and accountability for resources.

Quality Assurance

The process(es) or system(s) of an agency which provide(s) reasonable assurance that the internal control evaluation, improvement, and reporting process established in accordance with the OMB guidelines is carried out in a consistent, accurate, and reliable manner. These processes or systems will form part of the basis for the annual assurance letters and statement to the President and the Congress. An agency's quality assurance has several essential elements, including appropriate documentation for the internal control evaluation process; appropriate Inspector General role in the process; adequacy of resources and overall organization of the process; appropriate training for managers with internal control responsibilities; and assuring that actions taken will correct weaknesses permitting fraud, waste, or mismanagement.

Reasonable Assurance

Internal controls systems should provide reasonable, but not absolute, assurance that the objectives of the system will be accomplished. This concept recognizes that the cost of internal control should not exceed the benefit expected to be derived therefrom, and that the benefits consist of reductions in the risks of failing to achieve stated objectives. Estimates and judgments are required to assess the expected benefits and related costs of internal controls. Errors or irregularities may occur and not be detected because of inherent limitations in any internal control, including those resulting from resource constraints, or congressional restrictions. "Reasonable Assurance" is one of the Comptroller General's Standards for Internal Controls in the Federal Government.

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Segmentation

The process by which an agency identifies assessable units; that is, its programs and administrative functions. The inventory of assessable units developed as a result of this process must be appropriately detailed so as to provide a basis for the conduct of meaningful vulnerability assessments. OMB guidelines provide that all the agency activities, except those concerned with policymaking, should be included in the inventory. There is no single best method to segment an agency, particularly in light of variations in agency organization structure and responsibilities.

Testing Systems in Operation

Testing should be conducted on all critical system aspects and may include interviewing persons who operate the systems, observing operating procedures, examining system documentation, applying procedures on live transactions and comparing results, direct testing of computer-based systems by use of simulated transactions, and reviewing error reports and evaluating error follow-up procedures. Tests should be designed to disclose whether valid transactions are processed properly, and whether the system rejects invalid transactions. The tests should cover the entire transaction--from initial authorization through processing, posting to the accounts, and reporting. Accordingly, manual as well as automated operations should be included. In developing test plans, consideration should be given to the results of any prior system testing.

This testing criteria has been adopted by OMB and included in Appendix H of its publication, Guidelines for Evaluating Financial Management/Accounting Systems (May 20, 1985). In determining the tests that would be appropriate for any system, it is important to keep in mind that in most cases, using transaction testing as the key, more than one of the above techniques are needed to test all important aspects of an accounting system.

Vulnerability Assessment

A biennial review of the susceptibility of an assessable unit to the occurrence of waste, loss, unauthorized use, or misappropriation. OMB guidelines prescribe three basic steps for the conduct of vulnerability assessments: (1) analyze the general control environment, (2) analyze the inherent risk, and (3) perform a preliminary evaluation of existing safeguards. The primary purpose of vulnerability assessments is to determine if and in what sequence resources should be allocated for the performance of internal control reviews.

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APPENDIX VI

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301

COMPTROLLER

16 SEP 1985

Mr. Frank C. Conahan
Director, National Security and
International Affairs Division
U.S. General Accounting Office
441 G. Street, N.W.
Washington, D.C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Final Letter Report (GAO/NSIAD-85-116, OSD Case 6814)Draft Reports, "Department of Defense's Implementation of the Federal Managers' Financial Integrity Act (FMFIA)," dated July 29, 1985 (GAO Code 390017, OSD Case 6809), and related reports to the Military Departments (GAO Codes 390018 through 390020, OSD Cases 6810 through 6812) and the Defense Logistics Agency (GAO Code 390017, OSD Case No. 6813).

The DoD is pleased that the GAO acknowledged the Department's progress in successfully implementing the FMFIA. At the same time, the GAO expressed reservations as to whether the DoD had an adequate basis for reporting that the objectives of the FMFIA had been met. The GAO's reservations may be more a result of its limited evaluation criteria than uncertainties in the IMC process. Whereas the GAO generally relied on its criteria in assessing reasonable assurance, the DoD used its complete network of management systems and audits.

The DoD will continue to improve its guidance for the annual evaluation of accounting systems. The DoD, however, also will continue its view that the accounting systems provide adequate internal and fund control features and that the certified systems are in compliance with GAO accounting requirements, unless detailed audits prove otherwise. Along these lines, on May 23, 1985, the DoD issued an advance copy (to be finalized in September) of guidance requiring testing of accounting systems to assure that prescribed accounting requirements are satisfied.

Specific DoD comments on each of GAO's findings and recommendations are enclosed. The DoD appreciates GAO efforts in assisting the DoD to meet the requirements of the FMFIA. Thank you for the opportunity to comment on the draft reports.

Sincerely,

John R. Quetsch

John R. Quetsch
Principal Deputy Assistant Secretary of Defense
(Comptroller)

Enclosure

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GAO DRAFT REPORT - DATED AUGUST 8, 1985
(GAO CODE 390020 - OSD CASE 6811)

"DEPARTMENT OF THE NAVY'S IMPLEMENTATION OF THE FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)"

DOD COMMENTS

* * * * *

FINDINGS

- FINDING A: Internal Controls Evaluation Program Not Yet Fully Implemented. GAO noted that in FY 1984, the Navy reported 38 material internal control weaknesses, 12 Navy-wide and the remainder pertained to a specific command or activity. GAO also noted that the Navy report stated, taken as a whole, the Navy's evaluation of its internal controls provided reasonable assurance that objectives of the FMFIA were being met. GAO found, however, that the Navy reported the absence of automated data processing (ADP) contingency plans as a command specific problem, but five of the seven ADP facilities it visited did not have formal contingency plans as required by Navy regulations. GAO noted that a senior Navy ADP official stated the lack of contingency plans is a serious Navy-wide problem, although it was not reported as such. GAO also concluded that, if the Navy ADP managers continue under the assumption that compliance with OMB Circular A-71 satisfies its FMFIA requirements, a portion of ADP general controls and all of ADP applications controls will not be fully addressed. GAO also concluded that the Navy instruction on the FMFIA should reference the DoD ADP Internal Control Guideline issued in November 1984, and the Navy Auditor General's Audit Program. Further, GAO concluded that the Navy FMFIA instructions should state that FMFIA requirements cannot be met by only complying with OMB Circular A-71. The Navy, GAO found, was in the process of correcting 27 material weaknesses reported in FY 1983. Based on a sample of 5 actions, GAO found that corrective actions had been taken; however, the Navy does not routinely test corrective actions to determine effectiveness. GAO concluded that testing should be part of the corrective action process and should be completed before material weaknesses are removed from the Navy's tracking and followup systems. GAO also found that in FY 1984, the Navy achieved greater organizational coverage than in 1983, and its internal control evaluations were more effective; however, many of the activities visited had not established the required tracking and followup systems to monitor and ensure that internal control deficiencies are promptly corrected.

Note: Where applicable, page numbers have been changed to correspond with this report.

Enclosure

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GAO further found that Navy ship and aircraft squadron commanders were not required to perform internal control evaluations. A Navy official informed GAO that ship and aircraft managers will be required to evaluate internal controls starting in FY 1986. Finally, despite progress, GAO concluded that the Navy's FMFIA evaluation program needs to evolve further to provide an adequate basis for determining that the requirements of the FMFIA have been met. (Pages 2-3, 4-6, and 21-23)

DoD Response: **Partially concur.** The DoD agrees with the General Accounting Office summary assessment that the Navy made progress in developing and implementing the internal control program, as evidenced by increased coverage, greater number of assessments, improved identification and correction of weaknesses, and increased consciousness of managers to internal controls.

The Navy has taken or initiated actions which will correct problems identified by GAO and strengthen the overall Navy program. Issuance of Secretary of the Navy Notice 5230 on April 11, 1985, provided managers with the Department of Defense ADP Internal Control Guidelines. The guidelines clarify the difference in requirements between the FMFIA and the Office of Management and Budget (OMB) Circular on ADP security (OMB Circular A-71).

GAO indicated that a senior Navy ADP official stated the lack of contingency plans is a serious Navy-wide problem, although it was not reported as such. It should be noted that the area of ADP was not assessed by the Navy as highly vulnerable in the first biennial vulnerability assessment cycle; therefore, internal control reviews of this function were only selectively performed during the FY 1983 - FY 1984 cycle. Not enough reviews or problems were reported to warrant inclusion of lack of contingency plans as a Navy-wide problem. GAO made no report on ADP contingency plans in the Navy. While there may be a problem in ADP contingency plans, GAO appears to be adopting an inconsistent view of the role of management judgment in the FMFIA reporting process. On the one hand, it states that the judgment of a management official is sufficient to identify a material weakness, but strongly requires far more evidence to certify the adequacy of internal controls or the adequacy of accounting systems.

The Navy will reemphasize the requirement that commands and activities must establish and maintain tracking and followup systems for monitoring internal control deficiencies and that actions to correct deficiencies must be tested to ensure effectiveness.

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Presently, detailed program guidance is being drafted which will include the requirement for ship and aircraft squadron commanders to comply with the FMFIA by conducting internal control evaluations.

GAO concluded that the Navy's internal control evaluation program needs to evolve further to provide an adequate basis for determining that the requirements of the FMFIA have been met. However, the GAO criteria for determining compliance with the act are incomplete. Reasonable assurance of compliance must address the total management process of the Navy, including audit, inspection, internal review, and investigation activities; the nature and extent of standing policy and procedural directives; the assurance statements made by Navy officials; the internal control program itself; and any other information bearing on the subject. The compliance statement last year reflected the entire management process.

- FINDING B: Most Accounting Systems Do Not Conform With Comptroller General's Requirements. GAO noted that the Navy reported 5 of its 14 accounting systems substantially conformed with the Comptroller General's requirements. Of the 5 systems reported as being in compliance, GAO found the Navy did not adequately evaluate and test them in operation. Instead, the Navy relied on the results of a questionnaire; an approach GAO found to be inadequate. Accordingly, GAO concluded that the Navy did not have an adequate basis for reporting that the five systems were in conformance with the Comptroller General's requirements. Although GAO noted that the Navy was taking steps to improve its system evaluation process in FY 1984, by setting up a framework for determining whether its accounting systems meet the Comptroller General's requirements, GAO found the progress could be delayed for the following reasons:

  -- The Navy developed a draft master plan to monitor accounting system deficiencies and related corrective actions. However, since FY 1983, 6 of the planned corrective actions have slipped at least 1 year. GAO concluded that Navy decisionmakers would find this plan more helpful if it included and tracked interim and final milestone dates and estimated costs for all corrective actions. GAO also concluded that the Navy's FMFIA report to the Secretary of Defense should include final milestone dates for all corrective actions.

  -- The Navy field and headquarters managers did not adequately coordinate internal control reviews with accounting systems evaluations. At the field level, these evaluations were performed independently; at the headquarters level, the internal control weaknesses were

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generalized into such broad categories that, GAO concluded, relating those weaknesses to specific accounting subsystems was not possible.

-- The Navy did not develop an adequate followup system to track and monitor accounting systems deficiencies and related corrective actions. GAO concluded that such a system is essential to monitor and assure the actions developed to correct accounting systems deficiencies are promptly completed. (Pages 2, 6-7 and 24-30) Report)

DoD Response: **Partially concur.** The GAO report does not recognize the complete integrated program that Navy has developed; two major Navy initiatives (Corporate Planning Boards and Consolidated System Evaluations); and how all elements of Navy's integrated program feed the Navy Strategic Financial Management Master Plan. The integrated program, the Department of the Navy Evaluation and Control Process for financial management, contains the following elements:

- o The Department of the Navy Financial Management Inventory
- o The Department of the Navy Systems Manager/User Review Program
- o The Department of the Navy Consolidated Systems Evaluation Program
- o Department of the Navy Information Systems Architectures
- o Department of the Navy Corporate Planning Board Decisions
- o The Department of the Navy Strategic Financial Management Master Plan

The inventory is the basis for the process. While it is in process of being expanded to all financial management systems, it is presently complete for both operational and developmental accounting systems. In addition, all operational support systems that are not being replaced within three years are subjected annually to either a Systems Manager/User Review or a Consolidated Systems Evaluation. All developmental systems are subject to a cyclical Consolidated Systems Evaluation. Complete systems (not support systems) may be subject to an Information Systems Architecture review at any time. Once such an architecture has been completed, a Corporate Planning Board is established to monitor and control the architecture decisions. The results of all these elements feed the Department of Navy Strategic Financial Management Master Plan, as do any other inputs (e.g., audit reports).

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GAO did not recognize that the Department of Navy Consolidated Systems Evaluation Program addresses developmental as well as operational component systems. This provides a test of corrective actions for each developmental system. GAO also did not recognize that the Corporate Planning Boards continually monitor and control both the progress toward the implementation of architecture decisions (which are corrective actions) and the effectiveness of such corrective actions, or that the decisions of such boards are high level management approval for corrective actions.

GAO addressed the Department of Navy Strategic Financial Management Master Plan as one element of controlling corrective actions, and did not recognize that it is the repository of the results of all Navy initiatives to control corrective actions. This plan, issued on August 12, 1985, contains interim and final milestones, and will have an attachment showing costs when it is forwarded as a budget exhibit as required by OMB Circulars A-127 and A-11. As required by SECNAVINST 7000.18D of August 5, 1985, this plan will be updated and issued annually. This plan will be used for tracking and followup on corrective actions. However, Navy does not intend to show all project detail (including all project milestones) in the plan. It will show summary milestones for projects, and identify project plans where more detailed milestones can be found. Navy will take the FMFIA Section 4 report from this plan as a summary and reference this plan for further detail. This plan should fully meet the Navy needs for tracking and followup.

GAO apparently concluded that the Navy should fully coordinate all work performed under provisions of the FMFIA at both the field and headquarters levels to better identify accounting internal control weaknesses and needed corrections to specific accounting systems. The Department of the Navy is highly decentralized. Much of the input for both sections 2 and 4 is developed at the field level. However, the nature of the processes for each section is very different. The section 2 process is organization oriented with results being reported via the chain of command. The section 4 process is accounting system oriented. Results are based on both an annual review of applicable Component systems that make up each accounting system and detailed cyclical evaluations (Consolidated Systems Evaluations). The difference in the processes made full coordination difficult. Nonetheless, to better coordinate sections 2 and 4 work, the Navy issued clarifying guidance in April 1985.

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RECOMMENDATIONS

- RECOMMENDATION 1: GAO recommended the Secretary of the Navy's future annual statements on systems of internal accounting and administrative controls not report with reasonable assurance that the requirements of the FMFIA have been met until such time as the revised evaluation program provides an adequate basis to make such a determination. (Page 8)

  DoD Response: Nonconcur. The Navy internal control program does not represent the only means for determining compliance with the FMFIA; but rather the entire management process, as previously outlined, must be considered. Nonetheless, the GAO criteria (significance of identified weaknesses, status of corrective actions, comprehensiveness of the Navy program and quality of evaluations performed, and the extent to which accounting systems conform to the Comptroller General's requirements) should enter in the determination on whether there is reasonable assurance that compliance with the act has been met.

- RECOMMENDATION 2: GAO recommended that accounting systems not be reported in conformance with the Comptroller General's requirements until they have been adequately evaluated and tested in operation. (Page 8)

  DoD Response: Partially concur. The Navy accounting systems reported in conformance satisfactorily provide for fiduciary and management accounting control. All known material weaknesses were identified at length. Systems underwent extensive testing at the time of design and implementation and are further tested when changes and enhancements are effected in the normal course of operation. GAO and OMB guidance available at the time of the 1984 compliance statement was incomplete and occurred late in the process, and Navy's conformance statement were based on the totality of systems at the time. The Navy has embarked on a comprehensive consolidated systems evaluation and user manager review process in accounting systems evaluations for FY 1985 and the future. Adequate testing in operation will be a feature of that process. However, the nature and degree of testing should be a management decision. For example, testing of systems which are scheduled for replacement in the near-term should not normally be accomplished; usefulness of that kind of testing is in doubt. The DoD, therefore, agrees that evaluation and testing of accounting systems need to be performed, but with

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managerial decision judgment applied, rather than universally.

- RECOMMENDATION 3: GAO recommended that the Secretary of the Navy:

  -- fully coordinate all work performed under provisions of the FMFIA at both the field and headquarters levels to better identify accounting internal control weaknesses and needed corrections to specific accounting systems; and

  -- implement an effective tracking and followup system to monitor planned accounting systems corrective actions on an ongoing basis. (Page 8)

DoD Response: Concur. Sections 2 and 4 are coordinated at both the field and headquarters levels. At the headquarters level, Navy has developed a process to provide summarized results from section 4 to section 2. This summary information is used in the determination of accounting system compliance.

In August 1985, Navy also has issued the Department of the Navy Strategic Financial Management Master Plan, which identifies all improvement efforts for accounting systems and summarizes the milestones of individual projects. Navy has also improved the management control process of individual project efforts. It is through the Navy's Strategic Financial Management Master Plan and its related project planning processes that Navy will monitor the effectiveness and track the progress of planned accounting systems corrective actions on an ongoing basis.

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